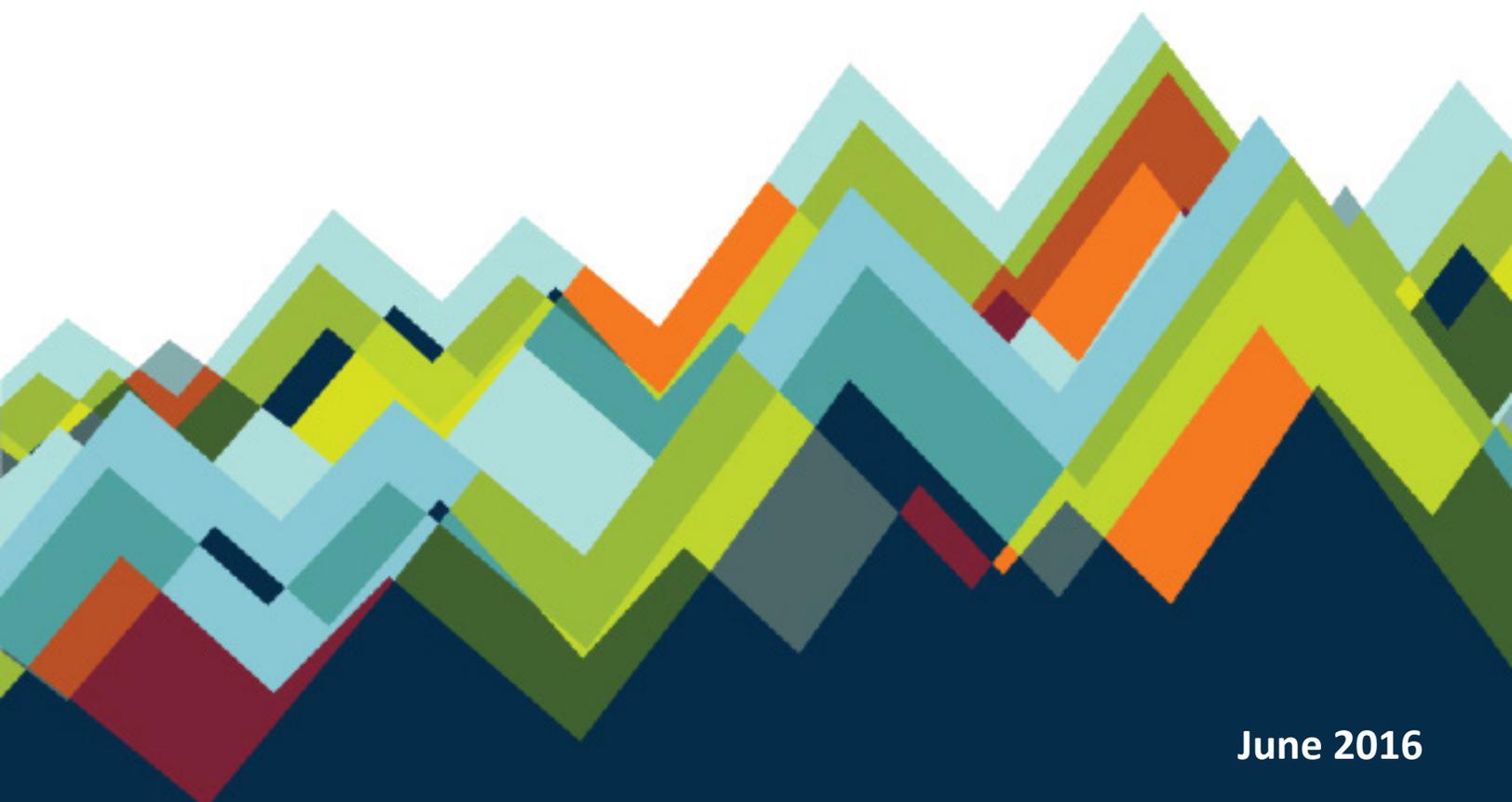




British Columbia  
Securities Commission

# **2016 Annual Compliance Report Card**

## British Columbia Securities Commission



June 2016



# BCSC 2016 ANNUAL COMPLIANCE REPORT CARD

This compliance report card summarizes the compliance strengths and weaknesses we found at BC-based portfolio managers (PMs), investment fund managers (IFMs), and exempt market dealers (EMDs) this past year (April 1, 2015 to March 31, 2016). We provide this information so that chief compliance officers (CCOs) can use it to understand our examination focus and improve their compliance programs.

## **Our firms**

At March 31, 2016, the BCSC regulated 114 firms and the associated individuals directly registered with the BCSC (excluding IIROC and MFDA firms and their dealing representatives). These firms consisted of:

- 87 adviser/IFM firms
- 27 dealer firms

We also continued to review the compliance of unregistered market participants that we thought might be required to register. These market participants comprised both issuers and finders that appeared to be in the business of trading in securities under registration and prospectus exemptions in BC.

## **Our approach to regulation - risk and outcomes based**

Our goal is to foster a culture of compliance among market participants. Where we find serious compliance failures or dishonest conduct, we will take decisive action.

To foster a culture of compliance among our registered firms, our relationship managers maintain communications with the firms assigned to them. They understand each firm's business and compliance program. We encourage firms to contact their relationship managers to discuss compliance-related issues or to report changes in their business or personnel. Please contact us if you do not know your relationship manager (see contact details at the end of this report card).

The BCSC uses a predictive risk model to assess the risks for BC-based registered firms. We take data from answers firms provide to our bi-annual risk questionnaires and the firm's examination results. The risk model helps us to predict the likelihood of compliance failures, and we rely on it and other tools to choose registered firms for compliance reviews. We generally tailor our compliance reviews to test our compliance concerns for each firm.

If we receive information or complaints that indicate any market participant is seriously noncompliant or dishonest, we conduct a "for cause" review.

# COMPLIANCE REVIEW FINDINGS

## Compliance review findings - strengths and weaknesses

### *Registered firms - positive findings*

We found these positive practices among firms with good cultures of compliance:

- As part of their KYC programs, they implemented policies to create new investment policy statements for each client every two years.
- They assessed CRM2 requirements ahead of implementation to address their applicability to the firms' specific business models, and contacted their BCSC relationship manager for clarification, where necessary.
- They implemented policies requiring their representatives to write notes to justify why a particular investment was suitable for a particular client at the time of purchase, in addition to obtaining the usual KYC information.
- They implemented procedures requiring their representatives to ask a client to repeat the risks and features of a product and the representatives' suitability assessment of it, as well as document what the client says.

### *Registered firms - top five deficiencies*

This year, we conducted 35 compliance reviews, and found an average of 4.29 deficiencies per review.

The top five deficiency categories were:

Deficiency Type	Number of Deficiencies	% of all Deficiencies
Policies and procedures	28	19%
Disclosures	20	13%
Registration administration	18	12%
Compliance officer function	11	7%
Know-your-client and suitability	10	7%
<b>Total</b>	<b>87/150</b>	<b>58%</b>

We tested 49 different deficiency categories and found 150 compliance deficiencies in total. The top five deficiencies represent approximately 58% of all of the compliance deficiencies we found.

# COMPLIANCE REVIEW FINDINGS

Examples of the compliance deficiencies we found in the various deficiency categories include:

## Policies and procedure manuals (PPMs)

- **PPMs did not fairly represent the firms' business operations.** We saw examples where firms had written policies and procedures that did not match actual practices. Some firms had policies and procedures, but did not apply them. We expect firms to tailor their PPMs to their operations to represent their actual business operations and practices.
- **Inadequate reviews of PPMs.** We saw examples where firms did not periodically review their PPMs. This failure resulted in PPMs that reflected outdated processes and information. We expect firms to perform regular, meaningful reviews of their PPMs to ensure they reflect current processes.
- **No evaluation of cyber-security risks.** Cyber-security risks continue to evolve. Firms that do not manage these risks will become targets. We expect firms to manage this risk by, at a minimum, including meaningful policies and procedures aimed at managing their cyber-security risks. These risks include data preservation and protection, network security, and client authentication.

## Disclosures and Relationship Disclosure Information (RDI)

- **RDI failures.** We identified ongoing deficiencies in RDI that firms must provide to their clients under section 14.2(2) of NI 31-103. The most common RDI deficiency we identified was the requirement in section 14.2(2)(m) to provide each client with a general explanation of their performance benchmarks. It also requires firms to provide information about client options for benchmark reporting, where firms offer their clients these options. This requirement has been in effect since July 15, 2014.

The Companion Policy to NI 31-103 gives guidance about the RDI requirements. We also encourage firms to review CSA Staff Notice 31-344 *CSA Review of Relationship Disclosure Practices* to assist them in improving their relationship disclosure practices. RDI practices are important because many clients rely on and make decisions based on a firm's RDI.

- **Client statements.** We found cases where firms sent clients quarterly statements generated from third party technology service providers that contained inappropriate boilerplate language stating that the statements may not be accurate, and suggesting clients rely on the custodian's records. We view this disclosure as inappropriate because registered firms are responsible for ensuring that all information presented to clients is accurate. Section 14 of the Securities Rules *Fair dealing*, requires firms to deal fairly, honestly, and in good faith with all their clients.

# COMPLIANCE REVIEW FINDINGS

## Registration administration - required filings

**National Registration Database (NRD) filings.** We saw examples where individual registrants overlooked their obligation to report changes in their registration information to the BCSC through the NRD. This includes changes to, or the addition of, outside business activities.

**NI 33-109 Registration information.** We expect individual registrants to report all officer or director positions held, as well as positions of influence. Schedule G, Item 10 of Form 33-109F4, requires registrants to disclose their current business and employment activities, including employment and business activities with their sponsoring firm and any employment and business activities outside their sponsoring firm. We found that registrants commonly overlook reporting the following paid or unpaid outside activities:

- Director or officer of personal holding corporations
- Director or officer of non-profit and/or charitable organizations
- Director or officer of related parties to the registered firm

## Chief compliance officer (CCO) functions

- **CCOs not following policies.** We found instances, particularly among our smaller firms, where CCOs did not follow their own policies and procedures. In larger firms, we found instances where CCOs missed carrying out their documented compliance procedures or carried them out inadequately.
- **CCO duties.** We observed cases where CCOs could not demonstrate they had performed compliance reviews under their PPMs. They did not keep any documentary evidence to support their compliance reviews. We also found examples where CCOs delegated compliance duties to others, with no oversight. The CCO (by title) bears responsibility for the firm's compliance program.

Section 5.2 of NI 31-103 outlines the responsibilities of CCOs, which include establishing, maintaining, and monitoring policies and procedures for assessing compliance by the firm and individuals acting on its behalf with securities legislation.

# COMPLIANCE REVIEW FINDINGS

## Know-your-client (KYC) and suitability

**KYC issues.** As in 2014 - 2015, we continued to see KYC problems, including:

- outdated KYC information, at times, several years old
- no evidence of KYC updates, despite significant life changes for clients
- KYC information that was not adequate enough to allow the firm to conduct a proper suitability assessment of the client
- registered individuals not following the firm's PPM requirements to collect, document, and retain KYC information
- CCOs not reviewing new client accounts to ensure all KYC information is collected
- CCOs not reviewing KYC information to ensure suitability of advice and/or investment products recommended by the firm's registered individuals

We regard KYC as the cornerstone obligation supporting suitability assessments. Knowing the client and assessing suitability are the fundamental responsibilities of a registrant. A registrant must take reasonable steps to ensure that a purchase or sale is suitable for a client, before it makes a recommendation, or accepts an instruction from the client, to buy or sell a security, or makes a purchase or sale of a security for the client's managed account. Without up-to-date KYC information, a registrant cannot meet its suitability requirements when recommending or making a purchase or sale for a client.

Registrants must make reasonable efforts to keep their clients' KYC information current. We consider information current if it is sufficiently up-to-date to support a suitability determination. For example, a portfolio manager with discretionary authority should update its clients' KYC information frequently.

## Other deficiencies

**Advertising and marketing.** As in 2014 - 2015, we continued to find firms using:

- unsubstantiated advertising claims
- benchmarks that were not adequately disclosed or explained to clients for their relevance

CSA Staff Notice 31-325 *Marketing Practices of Portfolio Managers* provides guidance on how registrants can meet their obligations. The Staff Notice suggests that firms should be able to substantiate all claims they make in their marketing materials, and ensure their marketing disclosure is up to date.

## How we treat non-compliance

When we see non-compliance, we can:

- require a firm to rectify its compliance program
- recommend imposing registration conditions to reduce the risk of non-compliance
- recommend suspending registration
- take enforcement action

# COMPLIANCE REVIEW FINDINGS

The CCO must ensure that every aspect of the firm's business complies with securities legislation. Where we find instances of non-compliance with regulatory requirements, we expect the CCO to take immediate action to resolve these deficiencies.

In 2015 - 2016, we identified an increased level of repeat deficiencies at firms. As a result, we imposed registration conditions on firms more frequently than we have in previous years.

Examples of registration conditions include:

- requiring a firm to hire a compliance monitor
- preventing a firm from trading in client accounts until it meets its compliance obligations
- preventing a firm taking on new clients.

We also consider charging costs for our compliance reviews where we see significant compliance failures, repeat deficiencies, or conduct that indicates the firm is not adequately managing its compliance program or the risks associated with its business.

## Examination focus 2016 - 2017

During the year ahead, we will continue to focus our compliance reviews of registered firms on the top five deficiencies. In addition, we will also focus on reviewing firms' compliance with CRM2 requirements.

This year, we will conduct targeted compliance reviews of:

- online advisers
- newly registered advisers
- select firms with head offices outside BC that have a large presence in BC and may present risk to BC clients

When facing reviews, CCO's of registered firms should consider the practices mentioned in this report card and the numerous guidance notices that the CSA has published. If you have questions about your compliance program, please contact the BCSC relationship manager for your firm, or any member of the BCSC compliance team.

## New regulatory requirements

We remind you to subscribe to the *Weekly Report*, so that you can get early information about legislative changes on the horizon.

# CONNECTING WITH THE BCSC

## Connecting with the BCSC

If you have questions or concerns, please contact your relationship manager, the Compliance Managers, or the Director.

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